

2002

Joint Regulation of Single Stock Futures: Cause or Result of Regulatory Arbitrage and Interagency Turf Wars?

David B. Esau

Follow this and additional works at: <https://scholarship.law.edu/lawreview>

Recommended Citation

David B. Esau, *Joint Regulation of Single Stock Futures: Cause or Result of Regulatory Arbitrage and Interagency Turf Wars?*, 51 Cath. U. L. Rev. 917 (2002).

Available at: <https://scholarship.law.edu/lawreview/vol51/iss3/9>

This Comments is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.

JOINT REGULATION OF SINGLE STOCK FUTURES: CAUSE OR RESULT OF REGULATORY ARBITRAGE AND INTERAGENCY TURF WARS?

David B. Esau⁺

In an increasingly global marketplace, there are growing concerns that the U.S. financial markets are not keeping competitive pace with innovation in investment products.¹ Congress responded to these concerns by passing the Commodity Futures Modernization Act (CFMA) in December 2000,² effectively repealing the Shad-Johnson Jurisdictional Accord of 1982 (Shad-Johnson).³

Shad-Johnson prohibited futures contracts⁴ on individual stocks and narrow-based stock indexes⁵ (collectively referred to as “security futures,” “security futures products,” or “single-stock futures”). The CFMA, in contrast, provides a regulatory framework that permits trading in security futures by granting jurisdiction to both the Commodity Futures Trading Commission (CFTC) and the Securities & Exchange

⁺ J.D. Candidate, May 2003, Catholic University, Columbus School of Law.

1. See *The Commodity Futures Modernization Act of 2000: Hearing on H.R. 4541 Before the House Comm. on Banking and Fin. Servs.*, 106th Cong. 125 (2000) (statement of Mark D. Young, Partner, Kirkland & Ellis on behalf of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange).

2. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified in scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., & 15 U.S.C.) (all cites to the Commodity Futures Modernization Act (CFMA) are to the bill section numbers).

3. The Shad-Johnson Jurisdictional Accord, Pub. L. No. 97-303, 96 Stat. 1409 (Oct. 13, 1982) (codified in scattered sections of 15 U.S.C.), was the result of an agreement between the Commodity Futures Trading Commission's Chairman, Phil Johnson, and the Securities and Exchange Commission's Chairman, John Shad, to clarify jurisdictional concerns between the two agencies and their respective products. See U.S. General Accounting Office Report to Congressional Requesters, *Issues Related to the Shad-Johnson Jurisdictional Accord* (Apr. 2000).

4. A futures contract is an “agreement that obligate[s] the holder to buy or sell a specific amount or value of an underlying asset, reference rate, or index at a specified price on a specified date.” GAO Report, *supra* note 3, at 1 n.2.

5. The term “narrow-based stock index” has had several definitions. Generally, a “narrow-based” stock index is an index comprised of nine or fewer securities, or an index with one or more component securities comprising a certain percentage of the index's weighting. See CFMA § 201 (5)(B)(2000). Interpretation of the definition of a “narrow based stock index” was published pursuant to the CFMA, at 66 Fed. Reg. 44,490-516 (Aug. 23, 2001).

Commission (SEC).⁶ The CFMA also mandates a timeframe for the two agencies to establish trading rules for such products.⁷

In examining the introduction of single-stock futures and narrow-based stock index futures to the financial world, this Comment focuses on the relationship between the CFTC and the SEC after the passage of the CFMA. This Comment examines the future popularity and regulation of security futures through analysis of the Shad-Johnson Accord, followed by a detailed look at the CFMA. This Comment then analyzes the jurisdictional concerns associated with security futures trading⁸ between the CFTC, which regulates futures contracts, and the SEC, which regulates securities. This Comment considers the rules promulgated by the two agencies relating to registration requirements, margin level differences, suitability standards, best execution methods, tax implications, and antifraud provisions. The Comment concludes with two predictions: (1) security futures will not be overwhelmingly popular, and (2) joint regulation compounds the problems rather than solves them.

I. AN EXAMINATION OF THE HISTORY BEHIND SECURITY FUTURES

A. *An Examination of the Problem: The Shad-Johnson Jurisdictional Accord of 1982*

A futures contract is an obligation to buy or sell a specified quantity of an underlying asset at a specified price at a specified time in the future.⁹ The CFTC has jurisdiction over futures contracts.¹⁰ The Commodity

6. See, e.g., CFMA §§ 202, 251 (2000).

7. See CFMA § 202(a)(5) (amending 15 U.S.C. § 78f(g)(5)(1994)). The CFMA required the SEC and CFTC to implement rules by August 21, 2001, for institutional investors and December 21, 2001, for retail investors. *Id.*; see also 66 Fed. Reg. 44,490 n.5 (Aug. 23, 2001).

8. Although widely accepted, the term “trading” in the context of futures contracts is not technically accurate. Each futures contract is an entity of its own and may be bought or sold. See *Leist v. Simplot*, 638 F.2d 283, 286 (2d Cir. 1980) (citing Glenn Willett Clark, *Genealogy and Genetics of “Contract of Sale of a Commodity for Future Delivery” in the Commodity Exchange Act*, 27 EMORY L.J. 1175, 1176 (1978)). A customer wishing to liquidate his assets on a futures transaction, technically takes an opposite position on an identical, though separate, contract, thereby effectively canceling out, or offsetting, his initial transaction. See *id.*

9. NATIONAL FUTURES ASSOCIATION, GLOSSARY OF FUTURES TERMS 13 (1995).

10. See Commodity Exchange Act, 7 U.S.C. § 2(a)(1) (2000). The CFTC has jurisdiction over futures contracts on, *inter alia*, agricultural and other tangible commodities, treasury bills, foreign currency, and broad-based stock index futures, as well as options on those products. 7 U.S.C. § 1-27 (2000). The CFTC does not, however, have jurisdiction over options on individual stocks. The SEC maintains that authority pursuant

Exchange Act (CEA), enacted during the New Deal in 1936, provides the statutory structure for regulating futures contracts.¹¹ The CEA was passed in response to a growing concern regarding manipulation in the commodities market.¹² Ultimately, the CEA was enacted to protect against wild market speculation¹³ and to shield farmers and the agricultural community from market manipulators.¹⁴

The federal securities laws are also a product of New Deal legislation.¹⁵ In the four years following the 1929 stock market crash, the value of the securities markets was slashed nearly in half.¹⁶ Much of this loss is attributable to fraudulent securities schemes.¹⁷ As a result, the decision was made to create a regulatory framework focusing on information disclosure.¹⁸ Enactment of the Securities Act of 1933 (1933 Act),¹⁹ which mandated such disclosure on securities being brought to market, was the first step in this process.²⁰

to the Shad-Johnson Jurisdictional Accord. Pub. L. No. 97-303, 96 Stat. 1409 (Oct. 12, 1982) (codified as amended in scattered sections of 15 U.S.C.).

11. 7 U.S.C. §§ 1-27 (2000).

12. S. REP. NO. 1431, 74th Cong., 1st Sess. 3 (1935) (stating that the legislation was aimed at remedying “trade practices involving the cheating of customers”).

13. The legislative history of the CEA implies that many senators viewed speculation in the commodities market as an activity akin to “gambling.” See, e.g., 62 CONG. REC. 9,404 (June 26, 1922) (remarks of Chairman Tincher, House Committee on Agriculture). Tincher stated: “I have never said that the sale of wheat for future delivery should be entirely wiped out . . . but have always said, and I still say, that to let a few gamblers manipulate the grain market was not only unfair to the consumer, but unfair to the legitimate trade.” *Id.*; see also *id.* at 9,412. Congress’ intent was to protect the unsophisticated investor against wild speculation and to prohibit fraud. *Id.* In 1928, the Department of Agriculture determined that federal statutory authority was needed to “insure fair dealing, and to prevent fraudulent practices” *Hearings on H.R. 11,952 Before the House Comm. on Agric.*, 70th Cong., 1st Sess. 7 (1928) (statement of Mr. J.W.T. Duvel, Chief, Grain Futures Administration, Department of Agriculture). Legislation was eventually passed to “protect the rights of customers as fully as possible.” H.R. REP. NO. 1551, 72d Cong., 1st Sess. 3 (1932).

14. Farmers have historically used futures contracts on commodities to hedge against price risk and ensure stability in their pricing powers. See *Leist v. Simplot*, 638 F.2d 283, 287-88 (2d Cir. 1980) (citing Abelardo Valdez, *Modernizing the Regulation of the Commodity Futures Markets*, 13 HARV. J. LEGIS. 35, 40 (1975); see also *id.* at 293-96).

15. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 6-7 & n.4 (3d ed. 1996).

16. See *id.* at 6.

17. See *id.*

18. See *id.* at 6-7.

19. 15 U.S.C. §§ 77a-77bbbb (2000).

20. See generally James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

The Securities Exchange Act of 1934 (1934 Act),²¹ which promised even broader investor protection, addresses the regulation of stock exchanges,²² margin requirements,²³ periodic disclosure,²⁴ proxy voting,²⁵ insider trading,²⁶ and prohibition of fraud.²⁷ The 1934 Act also created the Securities and Exchange Commission, giving it broad powers to oversee the new federal securities laws.²⁸ Both the 1933 Act and the 1934 Act have been amended several times, and other major federal securities legislation has been subsequently enacted.²⁹ Despite the various amendments and subsequent laws, the basic tenets of protecting investors and maintaining an orderly securities market have remained unaltered.³⁰

In the mid-1970s, a flurry of innovative financial products resulted in a drastic transformation of the securities and commodities markets.³¹ U.S. investors were inundated with new financial opportunities and more instruments with which to invest their money.³² This wave of activity,

21. 15 U.S.C. §§ 78a-78mm (2000).

22. *Id.* § 78f.

23. *Id.* § 78g.

24. *Id.* §§ 78l-78m.

25. *Id.* § 78n.

26. *Id.* § 78p.

27. *Id.* §§ 78i-78j.

28. *Id.* § 78d.

29. *See, e.g.*, The Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (2000); The Investment Advisors Act of 1940, *Id.* §§ 80b-1-80b-21 (2000).

30. *See* HAZEN, *supra* note 15, at 21-25.

31. *See Hearing on H.R. 4541, supra* note 1, at 43-45 (statement of Mark D. Young, Partner, Kirkland & Ellis on behalf of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchnage) (discussing how financial engineers on Wall Street have changed the landscape of investment products).

32. *Id.* Such products include, *inter alia*, swaps, hybrids, options, and security futures. Swaps, which were created in the late 1980s, are exchanges of one asset or liability for a similar asset or liability for the purpose of raising or lowering coupon rates to maximize revenue or minimize financing costs. GLOSSARY, *supra* note 9, at 26. Hybrids, which also began trading in the late 1980s, are financial instruments that use equity or debt securities or depository interests combined with features of either commodity futures or option contracts or both. Gregory Kuserk, *OTC Derivatives Regulation: Options, Swaps, Hybrids and Energy Contracts*, CFTC Summer Intern Training Program Presentation (July 24, 2001)(on file with author). Options contracts, which began trading in the early 1900s, but were banned in 1936 and reauthorized in 1974 by the CFTC, are contracts which give the buyer the right, but not the obligation, to buy or sell a specified quantity of a commodity at a specific price within a specific time. GLOSSARY, *supra* note 9, at 20.

coupled with amendments to the CEA,³³ raised new regulatory concerns for the CFTC the SEC.³⁴

In the late 1970s, a jurisdictional dispute arose between the CFTC and the SEC.³⁵ The CFTC granted the Chicago Board of Trade (CBOT) the authority to trade futures contracts on Government National Mortgage Association pass-through mortgage-backed certificates.³⁶ Both agencies, however, asserted jurisdiction over these products after the CFTC granted the power to the CBOT.³⁷ The SEC claimed that the products were securities, while the CFTC asserted that they were futures contracts.³⁸ The debate continued until 1981 when the SEC granted the Chicago Board Options Exchange (CBOE) the authority to trade options contracts on the same mortgage-backed certificates.³⁹ Not pleased that the CBOE was allowed to trade the certificates, the CBOT petitioned the United States Court of Appeals for the Seventh Circuit to set aside the SEC rules granting authority to the CBOE to trade the mortgage-backed certificates.⁴⁰ The court granted CBOT's petition and held that the CFTC had jurisdiction over the mortgage-backed certificates.⁴¹ Following the decision, the SEC and the CFTC sought once again to clarify their respective jurisdictions.⁴² The Shad-Johnson Accord established jurisdictional boundaries for the CFTC and the SEC by prohibiting futures contracts on individual stocks and narrow-based stock indexes.⁴³ The Accord gave the SEC the authority to regulate security-based options⁴⁴ and authorized the CFTC to regulate futures

33. See generally GAO Report, *supra* note 3. In 1974, the CEA was "amended to expand the definition of a commodity to include virtually anything -- tangible or intangible. Consequently, a security fell within the definition of a commodity." *Id.* at 5. The CEA was also amended to give the CFTC exclusive jurisdiction over options on futures. *Id.*

34. See *id.* at 5-6.

35. *Id.* at 5.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Bd. of Trade v. SEC*, 677 F.2d 1137 (7th Cir. 1982).

41. *Id.* at 1159-61.

42. Shad-Johnson Jurisdictional Accord, Pub. L. No. 97-303, 96 Stat. 1409 (Oct. 13, 1982) (codified as amended in scattered sections of 15 U.S.C.). The Accord was codified in the Securities Act Amendments of 1982, which amended the federal securities laws, and the Futures Trading Act of 1982, which amended the CEA. GAO report, *supra* note 3, at 5-6.

43. See *id.* at 6.

44. See *id.*

contracts on broad-based⁴⁵ stock indexes and individual government securities.⁴⁶

The ban on single-stock futures was intended initially to be a temporary solution until the two agencies could determine an appropriate regulatory scheme.⁴⁷ An agreement was never finalized, however, and the ban remained in effect until the passage of the CFMA in late December 2000.⁴⁸

B. An Examination of the Solution: The Commodity Futures Modernization Act

There are myriad reasons supporting the investment community's attempts to seek authorization to trade security futures products.

45. A "broad-based stock index" is any stock index that is not narrow-based. 66 Fed. Reg. 44,490, 44,491 (Aug. 23, 2001). Under the 1982 Shad-Johnson agreement, the CFTC was permitted to allow any stock index futures contract to be traded if the CFTC found that it was: "(1) settled in cash; (2) not readily susceptible to manipulation; and (3) reflected the market as a whole or a substantial segment of the market." GAO Report, *supra* note 3, at 6. After the CFMA was passed in December 2000, and the ban on security futures was lifted, the term "narrow-based index" was re-defined. 66 Fed. Reg. 44,490, 44,491 (Aug. 23, 2001); *see also* CFMA § 201(5)(B).

46. 7 U.S.C. § 2(a) (2000); *see also* *Messer v. E.F. Hutton & Co.*, 847 F.2d 673, 676 (11th Cir. 1988) (explaining that an action regarding T-bond futures raises no claim under federal or state securities laws, but does under the Commodity Exchange Act because the fundamental congressional design was to avoid duplicative regulation).

47. GAO Report, *supra* note 3, at 6; *see also* H.R. REP. NO. 97-565, pt.1, at 40 (1982), reprinted in 1982 U.S.C.A.N. 3871, 3889. "The agreement . . . [does] not permit the trading of futures on individual corporate and municipal securities. Both agencies, however, intend to devote further study to issues in this area with a view toward a recommendation to lift this restriction." *Id.*; *see also* *Hearing on H.R. 4541*, *supra* note 1, at 124 (statement of Mark D. Young, Partner, Kirkland & Ellis on behalf of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange).

48. Technically, the ban on security futures remained in effect until the latter half of 2001. 15 U.S.C.A. § 78f(g)(5)(West Supp. 2001) (stating that trading security futures is illegal for one year after the passage of the CFMA); CFMA, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified as amended in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). The CFMA required the SEC and the CFTC to implement a plan by August 21, 2001, for institutional investors and December 21, 2001, for retail investors to begin trading security futures. CFMA § 202(5)(amending 15 U.S.C. § 78f(g)(5) (1994)); *see also* 66 Fed. Reg. 44,490 n.5 (Aug. 23, 2001). Several factors, however, including interagency battles over final margin rules and the September 11, 2001 terrorist attacks, delayed the intended launch date until March, 2002. Alex Skorecki, *U.S. Regulatory Hurdles Delay Liffe Move: Exchange Chief Hits Out at Unexplained Postponements to Allow Trading in Single Stock Futures*, FIN. TIMES (LONDON), Jan. 23, 2002, at 3; *Daily Briefing*, ATLANTA J. & CONST., Oct. 9, 2001, at 2C; *see also* Commissioner Laura Unger, SEC, Address at the Catholic University of America, Columbus School of Law (Oct. 17, 2001). The trading delay ultimately extended beyond May of that year and into the second quarter of 2002. Bill Barnhart, *Single-Stock Futures Get Truly Timely*, CHICAGO TRIBUNE, Apr. 19, 2002.

Compelling arguments for passing the CFMA and allowing futures contracts on single stocks and narrow-based stock indexes include: (1) the need to stay competitive with other world markets; (2) the need to codify regulations for an already existing practice; and (3) the need to account for a changing role for the U.S. futures markets.⁴⁹

1. Falling Behind the Curve: Competitive World Markets and Innovative Investment Instruments

To keep pace with a continuously evolving and increasingly global marketplace, regulators sought means to ensure that the United States remained a competitive leader in financial products and services.⁵⁰ Federal Reserve Board Chairman, Alan Greenspan's congressional testimony regarding the CFMA indicates concern about the inevitability of U.S. stock futures trading on foreign markets:⁵¹

[T]here's just little question in my judgment that we're not all that far away from single-stock futures on U.S. stocks trading in other countries. And if we don't resolve this issue [of how to regulate security futures] Shad-Johnson will get resolved but not in a manner which I think would be desirable for any of us.⁵²

Chairman Greenspan predicted that foreign markets would begin trading futures contracts on U.S. stocks.⁵³ He also predicted that the foreign markets would directly compete with U.S. financial markets for business.⁵⁴

49. S. 2697 – *The Commodity Futures Modernization Act of 2000: Joint Hearing Before the Senate Comm. on Agric., Nutrition, and Forestry and the Senate Comm. on Banking, Hous., and Urban Affairs*, 106th Cong. 2-3 (2000) (statement of Sen. Richard G. Lugar, Chairman, Comm. on Agric., Nutrition, and Forestry).

50. See, e.g., *Hearing on H.R. 4541, supra* note 1, at 125 (statement of Mark D. Young, Partner, Kirkland & Ellis on behalf of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange) (noting that the "Swiss-German electronic exchange, called EVREX . . . has replaced the Chicago Board of Trade as the futures exchange with the highest trading volume"); see also *Joint Hearing on S. 2697, supra* note 49, at 3 (statement of Sen. Lugar, Chairman, Senate Comm. on Agric., Nutrition, and Forestry). Senator Lugar stated:

The goal of the legislation is to ensure that the United States remains a global leader in the derivatives marketplace. Already the United States has lost much of its leadership role in the exchange traded futures markets in Europe Congress has a good opportunity at this point to reverse this tide by enacting sound legislation.

Id.

51. *Joint Hearing on S. 2697, supra* note 49, at 21 (statement of Alan Greenspan, Chairman, Federal Reserve Board).

52. *Id.*

53. See *id.* at 21-22.

54. *Id.* at 21.

Today, Greenspan's concerns have been realized,⁵⁵ but the U.S. has been able to address these concerns by lifting the security futures trading ban.⁵⁶

Futures contracts on twenty-five "universal" single stocks began trading in London in January 2001, with an additional 107 listed since that date.⁵⁷ Several other foreign exchanges have begun trading these products as well.⁵⁸ As a general matter, the market that regulates stocks in these foreign countries also regulates futures.⁵⁹ Therefore, no jurisdictional issues arise as they do under U.S. law. Even though popularity in these foreign products is low to moderate,⁶⁰ U.S. regulators anticipate heavier trading once investors become better acquainted with the products.⁶¹ Although the CFMA was based partially on the anticipated popularity of the new products, the primary focus was to

55. As Chairman Greenspan predicted, the London International Financial Futures and Options Exchange (LIFFE) initiated a program to list several U.S. stock futures on its London Exchange in September 2000, just two months after his testimony before the U.S. Senate. See <http://www.liffe.com> (last visited May 12, 2002). As of May 12, 2002, twenty-one U.S. stocks traded on LIFFE. See *id.*

56. Press Release, Nasdaq Stock Market, Inc., LIFFE and Nasdaq Form Partnership to Offer Single Stock Futures in U.S. and Europe (Mar. 26, 2001), available at <http://www.nasdaqnews.com> (last visited Apr 17, 2002). The Nasdaq stock market and LIFFE announced a partnership in March 2001 to develop a security futures market. *Id.* This market will include U.S. stocks. See *id.* The joint venture between LIFFE and Nasdaq was scheduled to commence in the U.S., with between fifty and seventy-five products, as soon as regulatory action permitted trading. Melissa Allison, *Ex-CFTC Chief to Lead Stock Futures Joint Venture*, CHI. TRIBUNE, Aug. 30, 2001 (discussing a rival to the Nasdaq/LIFFE venture, a joint venture between the Chicago Board Options Exchange, the Chicago Board of Trade, and the Chicago Mercantile Exchange).

57. See Nasdaq Press Release, *supra* note 56, at n.2; see also www.liffe.com (last visited Apr. 17, 2002).

58. GAO Report, *supra* note 3, at 11. Some of the foreign exchanges that permit futures contracts on single stocks to be bought and sold include the Budapest Stock Exchange (Hungary), Bolsa de Derivados do Porto (Portugal), FUTOP Clearing Centre (Denmark), Helsinki Stock and Derivatives Exchanges (Finland), Hong Kong Futures Exchange (Hong Kong), Mexican Derivatives Market (Mexico), OM Stockholm Exchange (Sweden), South Africa Futures Exchange (South Africa), and the Sydney Futures Exchange (Australia). *Id.*

59. *Id.* (noting that "[i]n contrast to the United States . . . the regulator that oversees the futures market *also* oversees the state market")(emphasis added).

60. See Nasdaq Press Release, *supra* note 56 (describing how popularity of security futures on LIFFE has been somewhat slow). In 2001, single stock futures enjoyed "limited success." Single Stock Futures, at <http://www.fif.com/SingleStockFutures.asp> (last visited Apr. 17, 2002).

61. Allison, *supra* note 56 (describing how some see security futures eventually being successful, but they may not "hit the ground running") (quoting Jon Najarian, Founder, Mercury Trading).

remain competitive in providing investors with innovative investment strategies.⁶²

2. Regulation of an Already Existing Practice

Although the CFMA authorized trading in single-stock futures and narrow-based stock indexes, these products have been effectively traded for a number of years through a complex series of options trades, known as “synthetic security futures.”⁶³ Synthetic security futures avoid regulation because they allow the trading of security futures notwithstanding Shad-Johnson, albeit for twice the transactional costs.⁶⁴ In order to ensure an accurate and reliable regulatory structure, Congress passed the CFMA.⁶⁵ The CFMA eliminates the need for investors to conduct such complex and expensive transactions⁶⁶ by permitting non-synthetic security futures to be traded.⁶⁷

3. A New Role for the U.S. Futures Markets

As of the most recent CFTC annual report, over sixty-five percent of the average month-end open interest in the U.S. futures markets is based on underlying financial assets.⁶⁸ It is apparent that the U.S. futures market has changed drastically since the New Deal era, when the intended purpose of the CEA was to protect the agricultural

62. See *Joint Hearing on S. 2697*, *supra* note 49, at 22 (statement of Sen. Fitzgerald) (“If we do not repeal Shad-Johnson, we are going to be confronted with foreign nations that are offering individual stock futures on our American companies.”).

63. See GAO Report, *supra* note 3, at 9-10. The report stated:

Options on single stocks serve similar economic functions as would be served by futures on single stocks. For example, both products could be used to protect a stock position from a decline in price, or to speculate on an anticipated price change in the stock [O]ptions on single stocks can be used to replicate prohibited futures on single stocks. For example, by buying a call option on a single stock and selling a put option on the same stock, a single stock futures contract can be created synthetically.

Id. at 9-10. (footnotes omitted).

64. *Id.* at 10 (noting that “single stock futures could be more efficient and less costly than synthetic futures because they involve one futures transaction instead of two options transactions”).

65. CFMA, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified at scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., & 15 U.S.C.).

66. GAO Report, *supra* note 3, at 9-10. Synthetic security futures involve at least two transactions, as opposed to just one for the now-permitted security futures. See *id.* at 10.

67. CFMA, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified at scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., & 15 U.S.C.).

68. See 2000 CFTC Annual Report 103. Financial assets include foreign currencies, stock indexes, interest rates, insurance, and now, single stocks and narrow-based stock indexes. *Id.* at 124-35.

commodities markets from fraud and manipulation.⁶⁹ To account for this evolution of markets and to provide for a host of innovative products, Congress was compelled to modernize the regulatory structure of the U.S. futures markets.⁷⁰

II. PRE-EXISTING REGULATORY TENSION BETWEEN FUTURES AND SECURITIES: HOW JOINT REGULATION WILL COMPOUND CONFUSION IN THE FINANCIAL MARKETS

A. Are Security Futures Securities or Futures?

Congress had several reasons for passing the CFMA and for introducing single-stock futures and narrow-based stock index futures into the U.S. financial arena.⁷¹ The question that arises, though, is why Congress thought it was beneficial to appropriate regulation in the manner it did. The CFMA creates a framework for the CFTC and the SEC to jointly regulate security futures,⁷² but fails to provide much guidance regarding how to accomplish this daunting task. In rushing to market with a new and potentially unpopular product, Congress took the quick, but not necessarily most effective, avenue. By prescribing joint regulation, Congress adopted a structure of regulatory tension and legal uncertainty in the process.⁷³

The CFMA states that security futures should be regulated as both securities and futures.⁷⁴ Accordingly, there are situations in which joint

69. See *Leist v. Simplot*, 638 F.2d 283, 294-96 (2d Cir. 1980); see also *Hearings on H.R. 11,952*, *supra* note 13, at 7 (statement of Mr. J.W.T. Duvel, Chief, Grain Futures Administration, Department of Agriculture) (explaining that the purpose of the legislation was to "insure fair dealing and to prevent fraudulent practices").

70. See *Hearing on 4541*, *supra* note 1, at 43-44 (statement of Mark D. Young, Partner, Kirkland & Ellis on behalf of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange) (discussing how, in the past 15 years, financial engineers on Wall Street have changed the landscape of financial products).

71. *Joint Hearing on S. 2697*, *supra* note 49 (statement of Sen. Richard G. Lugar, Chairman, Comm. on Agric., Nutrition, and Forestry).

72. See generally, CFMA, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified at scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., & 15 U.S.C.) (mandating coordinated regulation of security futures products).

73. See Vanessa Blum, *Uncertainty Over New Stock Product: SEC, CFTC Pressured to Clarify Rules for Single-Stock Futures*, LEGAL TIMES, Aug. 20, 2001, at 1 ("Rather than actually fulfilling the contract, the parties calculate the profit or loss on paper and settle the matter in cash.").

74. CFMA, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified at scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., & 15 U.S.C.); see also Annette L. Nazareth, Director, Division of Market Regulation, SEC, Speech at Washington Congressional

regulation might create more trouble than it would solve. For example, the underlying security in a security futures transaction might never be delivered.⁷⁵ Instead, cash exchanges could be made on each transaction.⁷⁶ The underlying product may be stocks, but ownership rights in the stock might never transfer. A potential legal gap therefore exists when, for example, the SEC brings an action against an individual for committing fraud “in connection with the purchase or sale of any security.”⁷⁷ That security might never actually have been bought or sold. Instead, a contract based upon the value of that security would have been bought or sold.⁷⁸ Consequently, an action for fraud “in connection with the purchase or sale of a security” would be tenuous because there would be no actual “purchase” or “sale.”⁷⁹ Therefore, by granting jurisdiction to the SEC to prosecute fraud on security futures, Congress potentially contributed to the legal uncertainty enveloping these products. Inconsistencies exist between the CFMA, the rules promulgated thereunder, and the 1934 Act, as interpreted by common law.⁸⁰ Despite Congress’ intent, some argue that security futures are not securities at all and that Congress should have vested the regulatory authority solely in the CFTC.⁸¹

Conference (May 3, 2001), *available at* <http://www.sec.gov/news/speech/spch484.htm>; 146 CONG. REC. S11,926 (daily ed. Dec. 15, 2000) (statement of Sen. Lugar).

75. Blum, *supra* note 73. Notably, Commissioner Laura Unger, in a fashion that exemplifies the confusion and legal uncertainty that exists across industries over these products, said in October, 2001 that she has no sense of how often security futures will be cash settled versus physically settled. *See* Unger Address, *supra* note 48.

76. *See* Blum, *supra* note 73; *see also* Single-Stock Futures Trade, at <http://www.cnn.com/2001/BUSINESS/05/15/stockfutures.reut/> (last visited May 12, 2002) (“A future obligates the holder to buy or sell the security of a company . . . at a specified future date and price, although it likely most often would be settled in cash based on the stock price.”).

77. 17 C.F.R. § 240.10b-5 (2001).

78. Blum, *supra* note 73.

79. *Id.*

80. *See* 17 C.F.R. § 240.10b-5 (2001). An argument could be made that security futures should not constitute “securities” at all, and that Congress should not have overridden common law principles and defined them as such. *See e.g.*, SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (holding that an investment contract, for purposes of the Securities Acts is any contract, transaction or scheme whereby a person invests his money in a common enterprise with the expectation of profit based solely on the efforts of others); *United Hous. Found. v. Forman*, 421 U.S. 837, 848 (1975) (using an “economic reality” test to define the meaning of security, stating that important factors include alienability, the ability to liquidate, receipt of dividends, and control). Because a security futures contract holder does not receive dividends or voting power, the *Foreman* economic realities test may not classify a security futures contract as a “security.” *Id.*

81. *Id.*

Although a similar argument may be made for options on equities, the SEC has *sole* jurisdiction over options on equities.⁸² The SEC *must*, therefore, enforce securities fraud provisions on equity options in order to avoid want of regulation altogether.⁸³ Security futures, alternatively, are regulated by both agencies, thereby diminishing the level of certainty by subjecting traders to the whims and conflicts of both agencies.

The SEC has argued that it should be the sole regulator of security futures.⁸⁴ The SEC was concerned that security futures would act as a substitute for stocks, allowing investors to shop for the most advantageous regulation.⁸⁵ Consequently, both agencies' goals, in promulgating their respective rules, was to avoid the possibility of regulatory arbitrage by choosing a product in one market over another based upon that market's more favorable rules.⁸⁶ In arguing for sole jurisdiction over the products, the SEC maintained that security futures would substantially affect the cash securities market.⁸⁷ The SEC contended that its vested interest lies in protecting securities from manipulation and volatility.⁸⁸

82. 15 U.S.C. § 78c (2000).

83. *See id.*

84. GAO Report, *supra* note 3, at 5-6.

85. *Testimony Concerning H.R. 4541, The Commodity Futures Modernization Act of 2000 Before the House Subcomm. on Fin. and Hazardous Materials Comm. on Commerce* (July 21, 2000) (statement of Arthur Levitt, Chairman, SEC) (stating that "single-stock futures are undeniably a substitute for stocks and stock options . . . the [regulatory] framework must encourage fair competition among markets")(on file with author).

86. *Joint Hearing on S. 2697, supra* note 49, at 34 (statement of Arthur Levitt, Chairman, SEC)(stating that "[c]ompetitive market forces, rather than government regulation, should pick winners and losers"); *see also id.* at 28 (statement of Sen. Schumer) (arguing that he would "hate to see investors shopping as to which instrument to use or to buy").

87. *Id.* at 34 (testimony of Arthur Levitt, Chairman, SEC); *see also id.* at 23 (statement of Sen. Kerrey) ("The SEC claimed that one of the reasons the stock market crashed in 1987 . . . [was][t]rading and speculating the stock market [index futures].").

88. *Id.* at 34. The SEC has historically been concerned that futures on securities create unacceptable volatility in the cash market. *See* Daniel F. Zimmerman, *CFTC Reauthorization in the Wake of Long-Term Capital Management*, 2000 COLUM. BUS. L. REV. 121, 146 (2000) (quoting then-Chairman John Shad, Commodity Futures Trading Commission). "Stock index futures are the most highly leveraged and volatile segment of the stock markets. Billions of dollars of transactions in stock index futures, executed in a matter of minutes, have repeatedly sent the stock market into violent gyrations." *Id.*

*B. Analysis of Two Regulatory Structures and the Conflicting Rules
Imposed on Their Agents*

Avoiding duplicative and inconsistent regulatory enforcement was a chief concern of Congress, the SEC and the CFTC during the congressional debates over security futures.⁸⁹ Records suggest that members of Congress were reluctant to introduce security futures because of the inherent lack of legal certainty as to jurisdiction.⁹⁰ Hence, regulators had the same jurisdictional concerns their predecessors had in the early 1980s.⁹¹

In an attempt to allay some of its fears, Congress mandated that the CFTC and the SEC promulgate several rules pursuant to the CFMA.⁹² One such set of rules involves the cross-registration of brokers and dealers (collectively “BD” or “BDs”)⁹³ and futures commission merchants and introducing brokers (“FCM” or “FCMs”)⁹⁴ with the

89. GAO Report, *supra* note 3, at 6; *see also Joint Hearing on S. 2697, supra* note 49, at 27 (statement of Sen. Bennett) (“Don’t we want some degree of unity here where you deal with one set of regulations and you know that another regulator will not come in and penalize you for having done that?”).

90. *Joint Hearing on S. 2697, supra* note 49, at 27 (statement of Sen. Bennett); *see also id.* (statement of Sen. Schumer) (“[T]his bill creates regulatory disparity by substantially different regulatory frameworks for regulation.”).

91. *Compare id.* (stating that it is “always a turf war . . . and neither side wants to give up their turf”) (emphasis added), with Howard Simons, *What’s the Future for Single-Stock-Futures?*, at <http://www.thestreet.com/comment/futures/1271714.html> (last visited May 12, 2002) (describing the Shad-Johnson Accord of 1982 as a “turf war between the Securities and Exchange Commission and the Commodity Futures Trading Commission”) (emphasis added).

92. *See, e.g.,* Notice Registration as a Futures Commission Merchant or Introducing Broker for Certain Securities Brokers or Dealers, 17 C.F.R. pts. 3 & 170 (2001); *see also* Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934, 66 Fed. Reg. 45,138 (Aug. 21, 2001).

93. A “broker” is defined by the 1934 Act as any person engaged in the business of effecting transactions in securities for the account of others. 15 U.S.C. § 78c(a)(4) (2000). The Exchange Act defines a “dealer” as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, as a part of his regular business. *Id.* § 78c(a)(5).

94. A “futures commission merchant” is any individual or organization that solicits or accepts orders to buy or sell futures or options contracts and accepts money or other assets from customers in connection with such orders. GLOSSARY, *supra* note 9, at 13; *see also* 7 U.S.C. § 1a(20) (2000). An “introducing broker” is a firm or individual that solicits and accepts futures orders from customers but does not accept money, securities, or property from the customer. GLOSSARY, *supra* note 9, at 15; *see also* 7 U.S.C. § 1a(23) (2000). Because each agency’s terminology for one who deals in security futures products is different, they will be neutrally referred to hereafter as security futures products “agents.” While “agent” may not be the most legally accurate term, it is likely the least “commission-specific.”

opposite regulatory agency. This includes a BD's registration with the CFTC as a security futures product FCM, as well as an FCM's registration with the SEC as a security futures product BD.⁹⁵ Both agencies have ultimately adopted similar provisions.⁹⁶ However, the differences between the agencies' initial proposals for notice registration⁹⁷ illustrate the tension between the two regulatory structures. This tension could ultimately become the basis for future difficulties.

1. Inherent Tension: An Analysis of the Proposed and Final Rules Regarding Notice Registration

On May 17, 2001, the CFTC published, for comment, a proposed rule for "Notice Registration as a Futures Commission Merchant or Introducing Broker for Certain Securities Brokers or Dealers."⁹⁸ This rule became effective, without major modification, on August 17, 2001.⁹⁹ Adopted pursuant to CFMA mandate,¹⁰⁰ this rule establishes requirements for BDs already registered with the SEC to register as single-stock futures agents for purposes of trading security futures products.¹⁰¹ The CFTC rule allows an already registered BD to register to trade security futures by filing a simple one-page notice with the National Futures Association (NFA).¹⁰² This notice eliminates the need to re-register and reduces the possibility of FCMs obtaining a competitive advantage over BDs in the security futures market.¹⁰³ Congress attempted to achieve equality between industry agents in drafting the CFMA by amending section 4f(a)(2) of the CEA and section

95. To further strengthen the argument of regulatory disparity, it should be recognized that even something as simple as terminology can be a problem. *Compare* Notice Registration as a Futures Commission Merchant or Introducing Broker for Certain Securities Brokers or Dealers, 17 C.F.R. pts. 3 & 170 (2001) (referring to security futures agents as security futures products "futures commission merchants"), *with* Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the Securities Exchange Act of 1934, 66 Fed. Reg. 45,138 (Aug. 27, 2001) (labeling the same agents as security futures products "broker-dealers").

96. 17 C.F.R. pts. 3 & 170 (2001).

97. "Notice registration," as used in the CFMA, refers to the process of cross-registering with the opposite agency. CFMA § 203(a)(2000) (amending 15 U.S.C. § 78o(b)(11)(A)(2000)).

98. 66 Fed. Reg. 27,476 (May 17, 2001).

99. 66 Fed. Reg. 43,080 (Aug. 17, 2001).

100. CFMA § 203(a)(2000) (amending 15 U.S.C. § 78o(b)(11)(A)(2000)).

101. 66 Fed. Reg. 43,080 (Aug. 17, 2001).

102. 66 Fed. Reg. 27,476-77 (May 17, 2001); 66 Fed. Reg. 43,080-81 (Aug. 17, 2001).

103. 66 Fed. Reg. 43,080, 43,081 (Aug. 17, 2001) (describing how several comment letters to the CFTC's proposed notice registration rule asked that both agencies' rules be identical to avoid adverse advantages of BDs over FCMs).

15(b)(11) of the 1934 Act. These sections mandate that registration is effective with the submission of notice, if:

- (A) the BD or FCM is already registered as such with its own commission;
- (B) they limit their orders to security futures products;
- (C) in such a way that each commission may prescribe, the BD or FCM files written notice with the other commission;
- (D) the registration from the BD or FCM's own commission is not suspended; and
- (E) the BD or FCM is a member of a national association (National Securities Association for BDs or the National Futures Association for FCMs).¹⁰⁴

These five statutory requirements constitute essentially all the notice registration requirements established by the CFMA. However, the CFMA required each commission to make its own determination of what constitutes sufficient "notice."¹⁰⁵

The CFTC decided to require a one-page written notice with basic information to be filed with the National Futures Association.¹⁰⁶ In contrast, the SEC proposed a more complex procedure for FCMs to register as security futures agents.¹⁰⁷ Demonstrative of the differing cultures and regulatory structures of the two agencies, the SEC proposed that FCMs file Form BD, the same form filed by brokers and dealers registering with the SEC as full brokers or dealers.¹⁰⁸ Several comments, denouncing the SEC's proposed rules, indicate a fear that BDs might be given a competitive advantage in filing procedures over their FCM counterparts.¹⁰⁹

On August 27, 2001, the SEC published its final rules relating to "Registration of Broker-Dealers Pursuant to Section 15(b)(11) of the

104. CFMA § 203(a)(2000); Securities Exchange Act of 1934, 15 U.S.C. § 78o(b)(2000); Commodity Exchange Act, 7 U.S.C. § 4f(a)(2)(2000).

105. CFMA § 203(a).

106. 66 Fed. Reg. 27,476, 27,477 (May 17, 2001).

107. Proposed Registration of Broker Dealers Requirement of Securities Exchange Commission, 66 Fed. Reg. 34,042 (June 26, 2001) (to be codified at 17 C.F.R. pts. 240, 248, 249).

108. 17 C.F.R. § 240.15b1-1. Form BD is a more lengthy, complex, and scrutinizing form than that which the CFTC proposed to effectuate notice registration. *See* Notice Registration as a Futures Commission Merchant or Introducing Broker for Certain Securities Brokers or Dealers, 66 Fed. Reg. 43,080 (Aug. 17, 2001); *see also* 15 U.S.C. § 78o(a) (2000).

109. *See* 66 Fed. Reg. 43,080, 43,081 (Aug. 17, 2001).

Securities Exchange Act of 1934.”¹¹⁰ These rules were considered a scaled-back version of the initial proposal.¹¹¹ Under the final rules, an FCM, to register with the SEC as a security futures agent, must complete a new form, Form BD-N, to effectuate the registration.¹¹² Form BD-N is a new and moderated derivative of Form BD.¹¹³ The new form includes, essentially, those requirements mandated by the parallel CFTC registration process.¹¹⁴ These requirements include statements indicating that the entity registering meets the five statutory requirements for notice registration with the CFTC¹¹⁵ and other basic identifying information.¹¹⁶ Form BD-N will be maintained by the NFA, the same association that will maintain the notice registration forms filed by FCMs.¹¹⁷

The differences between the registration requirements illustrates the inherent tension that exists between the CFTC and the SEC. This tension exists not only between the agencies’ regulatory mentalities, but also between their regulatory structures.¹¹⁸

As a precursor to other potentially disparate regulatory treatment, the agencies’ notice registration requirements, at least initially, displayed the differing levels of regulation between the agencies. Another such example is the suitability requirements imposed on BDs by the securities industry.¹¹⁹ The CFTC has traditionally had a slightly more relaxed treatment for FCM recommendation requirements.¹²⁰

2. More Tension: Analysis of Conflicting Suitability Requirements

Similar to the business merger, cultures often clash when ideas merge. Although the alliance looks attractive on paper, there is a lack of

110. Final Rule on Registration of Broker Dealers by SEC, 66 Fed. Reg. 45,138 (Aug. 27, 2001)(to be codified at 17 C.F.R. pts. 240, 248, 249).

111. *Id.* at 45,144.

112. 66 Fed. Reg. 45,138 (Aug. 27, 2001)(amending 34 Act Rule 15b11-1).

113. *See id.* at 45,139.

114. *Compare id.* with 66 Fed. Reg. 27,476 (May 17, 2001).

115. *See supra* text accompanying note 104.

116. Final Rule on Registration of Broker Dealers, 66 Fed. Reg. 45,138-39 (Aug. 27, 2001).

117. *See id.* at 45,141 (stating that NFA will maintain form BD-N); *see also* 66 Fed. Reg. 43,080 (2001) (stating that the NFA will maintain the CFTC’s notice registration forms).

118. *See, e.g.,* Thomas A. Russo & Marlisa Vinciguerra, *Financial Innovation and Uncertain Regulation: Selected Issues Regarding New Product Development*, 69 TEX. L. REV. 1431 (1991).

119. *See, e.g.,* NYSE Rule 405.

120. GAO Report, *supra* note 3, at 25-26.

cohesiveness in the collective mentalities. The CFTC and the SEC were created for distinctly different reasons and serve substantially different purposes in their respective industries.¹²¹ Suitability requirements are a potentially uncertain area that security futures agents face in serving their clients.¹²² Because the SEC and the CFTC serve different functions, a stark contrast exists between their industries' respective suitability frameworks.¹²³

One of the primary goals in creating the joint regulatory framework for security futures was to limit regulatory "shopping."¹²⁴ This goal resulted, at least in part, because of the possibility of inconsistent enforcement of suitability requirements.¹²⁵ Arthur Levitt, then SEC Chairman, stated that he would "hate to see investors shopping as to which instrument to use or to buy for that reason."¹²⁶ Although many of the regulatory "shopping" problems have been resolved in terms of disparity between particular products, many of the requirements imposed

121. *Joint Hearing on S. 2697*, *supra* note 49 (statement of William Rainer, Chairman, CFTC)("[W]e have two wonderful industries, a securities industry . . . and the futures industry, and they have grown up in different regulatory environments."); *see also* James Newsome, CFTC Chairman, Address at CFTC Summer Intern Program (July 29, 2001) (describing the different roles of the CFTC and the SEC). Chairman Newsome explained that the CFTC is a protective regulatory agency designed to ensure stability and competitiveness, while the SEC is intended to protect the capital formation market. *Id.*; *see also* Unger Address, *supra* note 48 (embracing the role of the securities market as one of capital formation).

122. *See e.g.*, NASD Rules 2310, 2860, IM-2860-2.

123. *Testimony Concerning H.R. 4541*, *supra* note 85 (statement of Arthur Levitt, Chairman, SEC)("In the securities markets, recommendations that brokers make to investors are governed by the suitability rules of self-regulatory organizations subject to SEC oversight . . . [It] is quite different under the futures laws. Investors receive a one-time disclosure document informing them that they can lose money."). In general, the securities industry's suitability rule prohibits brokers from making unsuitable recommendations in light of the investor's objectives, experience, sophistication and financial status. *See, e.g.*, NYSE Rule 405 (requiring the broker to use "due diligence to learn the essential facts relative to every customer"); *O'Connor v. R.F. Lafferty*, 965 F.2d 893, 898 (10th Cir. 1992) (holding that to establish unsuitability based on fraud by conduct, the plaintiff must prove (1) that the broker's recommended securities which were unsuitable in light of the investor's objectives; (2) the broker recommended or purchased the securities with an intent to defraud; and (3) the broker exercised control over the investor's account). *See also* NFA Online News, *NFA Prepares to Regulate Security Futures Products*, at http://www.nfa.futures.org/news/newsFactsActions/n11qtr2001_3.html (last visited Aug. 6, 2001).

124. *Joint Hearing on S. 2697*, *supra* note 49 (statement of Sen. Schumer).

125. *See, e.g.*, *Testimony Concerning H.R. 4541*, *supra* note 85 (statement of Arthur Levitt, Chairman, SEC).

126. *Id.*

on security futures agents (such as notice registration, suitability, and best execution) were not finalized before initiation of trading.

Although the securities industry imposes strict suitability requirements on its agents, the futures market has traditionally had no suitability rule.¹²⁷ The “SEC and securities exchange officials are concerned that the lack of a futures market suitability rule would expose customers to risk.”¹²⁸ Security futures are complex, highly leveraged and potentially volatile products.¹²⁹ The concern is that FCMs would market these products to unsophisticated retail investors without any warning as to the dangers.¹³⁰ In drafting the CFMA, legislators required the NFA to adopt a suitability rule for security futures.¹³¹ Before security futures products could be traded, “NFA must qualify as a limited purpose national securities association.”¹³² Qualification standards include instituting customer protection and suitability rules similar to those of the National Association of Securities Dealers (NASD).¹³³ NFA asserted that it was continuously working with the SEC to develop rules equivalent to those enforced in the securities industry.¹³⁴ Under current rules, NFA requires “adequate risk disclosure,”¹³⁵ but NFA claims that it will eventually prohibit agents “from making unsuitable recommendations.”¹³⁶ Because of the difference between the securities and futures industries, finalization of rules has been slow.¹³⁷

The NFA rule-making process is a clear illustration of the tension between the securities and futures markets’ mode of operation and regulation. Another example of the tension between rules imposed on agents is the SEC’s best execution standard.¹³⁸

127. GAO Report, *supra* note 3, at 25.

128. *Id.*

129. GAO Report, *supra*, note 3, at 26.

130. *Id.* (stating that the “SEC and U.S. securities exchanges are concerned that retail customers buying or selling stock-based futures would be exposed to the risk of unlimited loss associated with an adverse price change . . . [potentially] undermin[ing] investor confidence”).

131. NFA Online News, *supra* note 123.

132. NFA, *Single Stock Futures Regulatory Update*, at <http://www.nfa.futures.org/news/singlestock/singlestock.pdf> (last visited May 12, 2002).

133. *Id.*

134. *Id.*

135. *Id.* (citing NFA Compliance Rule 2-30).

136. *Id.*

137. Bill Barnhart, *Single-Stock Futures Get Truly Timely*, CHI. TRIB., Apr. 19, 2002.

138. NFA, *Single Stock Futures Regulatory Update*, at <http://www.nfa.futures.org/news/singlestock/singlestock.pdf> (last visited May 12, 2002).

3. Even More Tension: Best Execution and Dissemination of Order Information

The NFA examined the need to adopt a best execution rule for security futures.¹³⁹ The NFA explains on its Web site that it is difficult to “know what the best execution issues will be.”¹⁴⁰ The securities industry, however, has such a requirement in place, and the potential for conflict exists if regulatory frameworks differ between industries.¹⁴¹

The securities industry’s best execution rule “requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer’s transaction.”¹⁴² In the absence of such a rule by the futures industry, questions arise as to the manner in which the futures industry will regulate not-so-scrupulous security futures agents.¹⁴³ It would be possible for a security futures agent, in the absence of such regulation, to avoid obtaining best execution prices for his customers and to avoid disseminating information on order execution. These practices are strictly regulated in the securities industry.¹⁴⁴

Equally troubling is the possibility that the securities industry may not impose its new broker price dissemination requirements on security futures agents.¹⁴⁵ In the summer of 2001, the SEC’s new dissemination rule for order execution went into effect.¹⁴⁶ The rule requires market centers and BDs to make publicly available periodic reports of customer order execution quality statistics and routing practices.¹⁴⁷ The new dissemination rule, however, will not likely be in effect for security

139. *Id.*

140. *Id.*

141. GAO Report, *supra* note 3, at 27.

142. *Workshop on Operations Issues for Single Stock Futures*, SIA Operations Conference 21 (Apr. 28, 2001) (describing NASD’s best execution standards and questioning whether those standards would apply to the security futures market).

143. *See id.* at 21-22.

144. *Id.*

145. *Cf.* Disclosure of Order Execution and Routing Practice, 17 C.F.R. § 240.11Ac1-5 (2000) (explaining that Rule 11Ac1-5, which mandates dissemination of order execution, will not apply to orders for listed options). Because commodity futures laws generally track securities laws, *see Hlavinka v. Comm. Futures Trading Comm’n*, 867 F.2d 1029, 1034 (7th Cir. 1989), and because regulators have agreed that equity options and security futures are economically similar, *see* GAO Report, *supra* note 3, at 9-10 (“Options on single stocks serve similar economic functions as would be served by futures on single stocks.”), it is likely that the two products will be regulated similarly, and thus unlikely that security futures will be included in the dissemination rule either.

146. *See generally* Disclosure of Order Execution and Routing Practice, 17 C.F.R. § 240.11Ac1-5 (2000).

147. *See* Laura Unger, *Timeless Principles of Investing in an Electronic Age* (May 6, 2001), at <http://www.sec.gov/news/speech/spch487.htm>.

futures products.¹⁴⁸ Despite regulators' attempts to achieve regulatory parity between security futures and their underlying equities,¹⁴⁹ differences invariably exist. One product may, therefore, ultimately have a competitive regulatory advantage over another.

The next section of this Comment addresses the legal uncertainty of security futures products. The tension between the prosecution of fraud by the CFTC and the SEC is discussed, as well as issues relating to margin level parity and the debate over how to tax security futures. These discussions demonstrate the inherent inconsistencies between securities and futures regulation.

C. Analysis of Two Regulatory Structures and the Conflicting Rules Regarding Margin Levels

Another concern for regulators authorizing security futures products is the effect the products may have on the cash and options markets.¹⁵⁰ Arthur Levitt noted that "the framework must encourage fair competition among markets."¹⁵¹ Because margin levels generally differ among financial instruments,¹⁵² regulators wanted to ensure that no particular product obtained an unfair regulatory advantage over others.

148. Cf. Disclosure of Order Execution and Routing Practice, 17 C.F.R. pt. 240 (2000) (citing cost-benefit analysis as not warranting the placement of these dissemination rules on options); see also *supra* note 145.

149. See *Joint Hearing on S. 2697*, *supra* note 49, at 27 (statement of Sen. Schumer); see also *id.* at 11 (statement of Alan Greenspan, Chairman, Federal Reserve Board of Governors).

150. *Joint Hearing on S. 2697*, *supra* note 49, at 17 (testimony of Lawrence Summers).

151. *Id.* at 33 (statement of Arthur Levitt, Chairman, SEC).

152. Compare margin definition in securities industry:

Traditionally, stock margin has been used to control the allocation of credit, reduce the risk of price instability, and protect investors from becoming overly leveraged [T]he *minimum down payment* that a customer must pay to a broker to fund a stock purchase. The remainder of the purchase price can be borrowed from the broker, with the broker then retaining the stock as collateral on the loan.

GAO Report, *supra* note 3, at 21 (emphasis added) *with* the definition of margin in the futures industry:

An amount of money deposited by both buyers and sellers of futures contracts and by sellers of option contracts to ensure performance of the terms of the contract (the making or taking delivery of the commodity or the cancellation of the position by a subsequent offsetting trade). *Margin in futures is not a down payment, as in securities, but rather a performance bond.*

GLOSSARY, *supra* note 9, at 16-17 (emphasis added).

Stocks generally have substantially higher margin requirements than options or futures.¹⁵³ Investors buying stock on margin in the cash market are subject to a fifty percent margin requirement.¹⁵⁴ In contrast, margins on futures contracts are much lower and generally range from one to seven percent.¹⁵⁵ The requirement for options on equities is twenty percent of the underlying security.¹⁵⁶ The different rates illustrate the radically diverse roles margins play within each industry. These differing rates and varying purposes of margin requirements across industries led regulators to conclude that they should “level [the] playing field” to avoid the possibility of regulatory arbitrage.¹⁵⁷ “Competitive market forces, rather than government regulation, should pick winners and losers.”¹⁵⁸

The CFMA requires that initial and maintenance margins for security futures be set at levels comparable to those for options.¹⁵⁹ Defining the word “comparable” presented difficulty for those developing the regulatory framework.¹⁶⁰ Attempting to achieve regulation parallel to options, the CFMA granted authority to the Board of Governors of the Federal Reserve System to establish this framework for security futures.¹⁶¹ In turn, the Federal Reserve used its authority, granted by CFMA, to re-delegate that responsibility to the SEC and the CFTC for joint regulation.¹⁶² On October 4, 2001, the two agencies released proposed rules that were scheduled to be finalized by mid-December 2001,¹⁶³ but did not receive final approval until after May, 2002.

153. See Credit by Brokers and Dealers (Regulation T), 12 C.F.R. § 220.1-220.132 (2001); *Joint Hearing on S. 2697*, *supra* note 49, at 18 (testimony of Alan Greenspan).

154. Credit by Brokers and Dealers (Regulation T), 12 C.F.R. § 220.1-220.132 (2001).

155. Howard Simons, *What's the Future for Single-Stock-Futures?*, at <http://www.thestreet.com/comment/futures/1273362.html> (last visited Oct. 25, 2001); *see also Joint Hearing on S. 2697*, *supra* note 49, at 18 (testimony of Alan Greenspan).

156. *See, e.g.*, NASD Rule 2520; Chicago Board Options Exchange Rule 12.3; New York Stock Exchange Rule 431; American Stock Exchange Rule 462.

157. *Joint Hearing on S. 2697*, *supra* note 49, at 17 (testimony of Lawrence Summers).

158. *Id.* at 33 (statement of Arthur Levitt, Chairman, SEC); *see also id.* at 28 (statement of Sen. Schumer) (“[N]either regulation nor the lack of it should pick winners and losers among products or exchanges and fair competition should.”).

159. CFMA § 206(b)(2)(B)(iii) (2000) (amending 15 U.S.C. § 78g (1994)).

160. 66 Fed. Reg. 50,720 (Oct. 4, 2001) (to be codified at 17 C.F.R. pts. 41 & 242).

161. CFMA § 206(b)(1) (2000) (amending section 7(c) of the 1934 Act, 15 U.S.C. § 78(g)(c)(2) (1994)).

162. *Id.* The Federal Reserve delegated that authority by letter dated March 6, 2001. *See* 66 Fed. Reg. 50,720, at Appendix B (Oct. 4, 2001).

163. Customer Margin Rules Relating to Security Futures, 66 Fed. Reg. 50,720 (Oct. 4, 2001) (to be codified at 17 C.F.R. pts. 41 & 242); *see also* 66 Fed. Reg. 55,608 (Nov. 2, 2001) (extending the deadline for comment on the proposed margin rules relating to

The concern that different margin requirements for different products would lead to unfair advantages also prompted fears that lower margins would give greater leverage to investors.¹⁶⁴ Greater leverage, regulators argued, effectively increases the potential for investor loss.¹⁶⁵ The fear of investors having too much leverage is also a product of the two industries' different approaches to margin time frames.¹⁶⁶

Options and futures margins are paid at least daily to cover contracts that are decreasing in value.¹⁶⁷ Alternatively, margins on securities must be covered within five days of the trade.¹⁶⁸ Because stocks can be extremely volatile, the SEC has argued that daily, or even hourly, margin calls on leveraged security futures contracts may be too dangerous for retail investors.¹⁶⁹

The counterargument, however, is that more frequent margin calls serve to alleviate volatility because they enable investors to "liquidate losing positions before more significant losses can accumulate."¹⁷⁰ One thing is certain, each industry's margin time frame and margin level requirements constitute different approaches for different purposes, which illustrates the tension existing between the two industries.

D. Analysis of the Tax Consequences of Security Futures

Security futures will not be subject to the same federal income tax treatment as other futures contracts.¹⁷¹ Capital gains on security futures will have the same tax treatment as those on the underlying security; a

security futures from November 5, 2001, to December 5, 2001). The proposed rules establish margin levels for security futures at twenty percent of the current market value of the position. 66 Fed. Reg. 50,720 (Oct. 4, 2001) (to be codified at 17 C.F.R. pts. 41 & 242). This requirement appears to be consistent with the initial and maintenance margins for equity options, which the CFMA requires. CFMA § 206(b)(2)(B)(iii) (2000) (amending 15 U.S.C. § 78g (1994)).

164. GAO Report, *supra* note 3, at 21.

165. *Id.*

166. *Id.*

167. *Id.* at 23.

168. *Id.* at 21.

169. *Id.* at 23. The set of rules proposed by the SEC and the CFTC in October 2001, would require the initial margin to be collected within three business days of the trade. 66 Fed. Reg. 50,730 (Oct. 4, 2001) (to be codified at 17 C.F.R. pts. 41 & 242). This is somewhat of a compromise between the five-day requirement in the securities market and the more frequent collection in the futures market. *See id.*

170. GAO Report, *supra* note 3, at 23.

171. Mutual Fund Café, *The Commodity Futures Modernization Act of 2000: Watershed Legislation for Derivatives* (May 2001), at <http://www.mfcafe.com/legal/lr/html> (citing Pub. L. No. 106-554 (2000), section 1234B of the Internal Revenue Code, enacted as part of the Consolidated Appropriations Act of 2001).

parallel to the tax liabilities that options on stocks receive.¹⁷² Comparable to other rules promulgated pursuant to the CFMA, regulators have sought parity between equity options, security futures, and cash securities in attempting to avoid any sort of regulatory arbitrage.¹⁷³

Distinctions between the industries are, however, inevitable. Inherent differences between futures and stocks preclude them from being regulated with absolute parity.¹⁷⁴ An investor wishing to avoid taxes on stocks has the option of deferring capital gains as long as he or she wishes.¹⁷⁵ This results in the investor being able to effectively choose when to realize capital gains and whether those gains will be short or long term.¹⁷⁶ “Because stocks have no maturity date other than the life of the issuing corporation, this deferral can endure for years.”¹⁷⁷ Hence, the investor is essentially the master of his tax domain.

Alternatively, futures are taxed at regular intervals (the expiration date of the contract) and because most futures contracts are shorter than one year, they must realize short-term capital gains,¹⁷⁸ which are taxed at the taxpayer’s ordinary income rate.¹⁷⁹ Because long-term capital gains rates are generally lower than their short-term counterparts, the result is a significant tax disincentive to invest in security futures over cash equities.¹⁸⁰

Cash stocks also receive a competitive advantage in some of the most heavily traded investment vehicles. “[M]ost tax-advantaged accounts such as IRAs, . . . 401(k)s [and] pension funds . . . are restricted in their use of futures and other derivatives”¹⁸¹ Because a major portion of the investor community trades specifically for their retirement

172. See 26 U.S.C.A. § 1234B(a)(1) (2001).

173. *Joint Hearing on S. 2697*, *supra* note 49 (statement of Sen. Schumer) (“[S]ingle-stock futures [should] be allowed to be traded if and only if we could achieve regulatory parity for futures and their underlying equities.”); see also Annette L. Nazareth, Director, Division of Market Regulation, SEC, Speech at Washington Congressional Conference (May 3, 2001).

174. GAO Report, *supra* note 3 at 25-26.

175. Simons, *supra* note 155.

176. *Id.*

177. *Id.*

178. 26 U.S.C. § 1222(1)(2000) (defining a short-term capital gain as a “gain from the sale or exchange of a capital asset held for not more than one year”); see also Simons, *supra* note 155.

179. See 26 U.S.C. § 1(h)(2000).

180. Simons, *supra* note 155.

181. *Id.*

accounts,¹⁸² which are usually tax advantaged, relinquishing those advantages has the potential to negatively affect the popularity of security futures products.¹⁸³ The tax implications, though not a direct product of congressional intent, demonstrate another area of regulatory tension between securities and futures.¹⁸⁴

E. Fraud

Fraud and market manipulation provisions constitute integral components of the SEC's and the CFTC's regulatory frameworks and daily operations.¹⁸⁵ Despite the common purpose and intent, the agencies' rules governing market manipulation and fraud are vastly different in both their construction and enforcement.¹⁸⁶

Because security futures may be regulated as securities and as futures,¹⁸⁷ the SEC and the CFTC were concerned that joint regulation might be overly burdensome and could impair each agency's enforcement against fraudulent practices.¹⁸⁸ The CFMA addressed this issue by granting each agency authority to initiate enforcement proceedings, subject to notification to the opposite agency.¹⁸⁹ The CFMA failed to contemplate, however, that each agency's antifraud rules are different in their orientation and enforcement.¹⁹⁰ Hence, legal uncertainty and tension are inevitable.

182. See ALAN R. PALMITER, *SECURITIES REGULATION 4* (Examples & Explanations Series, Aspen Publishing 1998) (describing how, as of 1995, pension fund investment is the fastest growing category of U.S. equity investors, constituting twenty-two percent of the market).

183. See 146 CONG. REC. S11,926 (daily ed. Dec. 15, 2000) (statement of Sen. Lugar).

184. *Id.*; see also Simons, *supra* note 155.

185. See generally *Testimony Concerning H.R. 4541*, *supra* note 85 (statement of Arthur Levitt, Chairman, SEC).

186. See GAO Report, *supra* note 3, at 23-24.

187. CFMA § 201 (2000) (modifying the CEA, 7 U.S.C. § 1(a)(31)(1994), and the 1934 Act, 15 U.S.C. § 78c(a)(55)(A)(1994)) (defining a security future as a security, and specifically, a contract for sale for future delivery of a single security or of a narrow-based security index); see also Nazareth Speech, *supra* note 173; 146 CONG. REC. S11,926 (Dec. 15, 2000) (statement of Sen. Lugar).

188. *Joint Hearing on S. 2697*, *supra* note 49 (statement of William Rainer, Chairman, CFTC). See generally *Testimony Concerning H.R. 4541*, *supra* note 85 (statement of Arthur Levitt, Chairman, SEC).

189. CFMA §§ 204, 205 (2000); see also Key Aspects of the Commodity Futures Modernization Act of 2000, at <http://www.morganlewis.com/wpcommodity.htm> (last visited May 12, 2002).

190. Zimmerman, *supra* note 88, at 148. Another troubling aspect of the agencies' differing antifraud rules is the potential uncertainty surrounding insider trading and

1. Antifraud Rules

The differences in regulatory structures present the possibility of inconsistent *and* duplicative enforcement. One agency may initiate enforcement proceedings while the other deems proceedings unnecessary.¹⁹¹ Alternatively, though equally as troubling, both agencies may pursue a claim, thereby subjecting violators to something analogous to double jeopardy.¹⁹² This Comment compares the antifraud provisions in Section 4b of the CEA (4b)¹⁹³ and Section 10(b) of the 1934 Act¹⁹⁴ and Rule 10b-5¹⁹⁵ (10b-5) promulgated thereunder.

a. Does the Restrictive “For or on behalf of” Language in 4b Apply to Institutional Investors?

Section 4b(a)(2) of the CEA,¹⁹⁶ in relevant part, bars fraud by “any person, in or in connection with any order to make, or the making of, any contract of sale of any [futures contract] . . . made, or to be made, *for or on behalf of any other person.*”¹⁹⁷ The problematic language that exists, at least in the security futures context, is the phrase “for or on behalf of any other person.” The same language does *not* exist in 10b-5.¹⁹⁸

The troubling aspect of this language pertains to how 4b, the principle antifraud and antimanipulation provision of the CEA,¹⁹⁹ applies to security futures transactions between principles. The uncertainty of this language leaves unanswered the question of whether security futures transactions conducted without intermediation by brokers or other

beneficial ownership issues of security futures. GAO Report, *supra* note 3, at 40-41; *see also* Single Stock Futures Workshop, *supra* note 142.

191. *Cf. Joint Hearing on S. 2697*, *supra* note 49 (statement of William Rainer, Chairman, CFTC) (“CFTC staff express[ed] concern that an umbrella approach, meaning the application of the panoply of both securities and commodities regulations to these products, could result in overly burdensome regulation.”).

192. *Id.* Both agencies may decide to prosecute and could subsequently reach inconsistent conclusions, thereby ultimately contributing to the legal uncertainty surrounding security futures. “[I]n the immediate future [security futures] will present an array of novel challenges in interpreting securities law.” Frank Partnoy, *Some Policy Implications of Single-Stock Futures*, Law and Economics Research Paper No. 10, University of San Diego School of Law 1, at http://papers.ssrn.com/paper.taf?abstract_id=261896 (last visited Oct. 25, 2001).

193. 7 U.S.C. § 6b (2000).

194. 15 U.S.C. § 78j (2000).

195. 17 C.F.R. § 240.10b-5 (2001).

196. 7 U.S.C. § 6b (1994).

197. *Id.* (emphasis added).

198. *See* 17 C.F.R. 240.10b-5 (2001).

199. 146 CONG. REC. S11,926 (Dec. 15, 2000) (statement of Sen. Lugar).

persons acting “for or on behalf of” other parties, are afforded 4b protection against fraud and manipulation. If 4b does not afford protection in this situation, then conceivably, principle-to-principle transactions, which may include most trades conducted at the institutional level,²⁰⁰ are not regulated by the futures antifraud provision.

The legislative history of the CEA includes some indication that 4b was proposed to act as a general antifraud provision.²⁰¹ It also illustrates, however, that 4b was intended to apply only to brokers acting “for or on behalf of” their customers.²⁰² Senator Norris indicated that “[Section 4b(a)] applies to an operator on the board of trade who is using a client’s money for investment . . . [and] [t]he only purpose of the . . . [provision] is to protect money that is really a trust fund.”²⁰³ It is therefore a stretch to apply 4b to transactions between principles because the principles would not be acting “for or on behalf of” anyone, except themselves.

Congressional hearings on the CFMA imply that Congress knew the “for or on behalf of” language was problematic.²⁰⁴ Congress left 4b intact, however, expressly declining to amend that specific provision.²⁰⁵ Instead, it inserted language in several places in the Act, in provisions not related to security futures, that appears to broaden the applicability of 4b. This language specifies that 4b would apply to certain categories of non-intermediated transactions between principles without anyone

200. The CFMA prohibits security futures trading between principles before August 21, 2001. CFMA § 202 (2000).

201. 80 CONG. REC. 7,871 (May 25, 1936) (statement of Sen. Robinson) (“[T]he object of the legislation is, or should be, to prevent deceptive or fraudulent transactions. Any language which accomplishes that end is worthy of consideration.”). *But see id.* (stating that a broker “has no right to [buy and sell for his clients] in a way that will sacrifice the interests of one client . . . for his own personal advantage” because he an agent).

202. *Id.*

203. 80 CONG. REC. 7,911 (Apr. 26, 1936) (statement of Senator Norris); *see also* H.R. REP. NO. 1522, 73d Cong., 2d Sess., at 5 (May 9, 1934) (stating, in a bill with language similar to CEA § 4b, that the provision “prohibits traders in acting for customers in futures transactions to cheat, defraud, or deceive customers”); H.R. REP. NO. 1551, 72d Cong., 1st Sess. at 2-3 (June 7, 1932) (stating, in a bill with language similar to CEA § 4b, that the antifraud provision was needed because “those who trade in the futures markets are in no position to obtain the necessary evidence with which to proceed against unscrupulous dealers. They are not even in a position always to know the extent to which they have been cheated by unscrupulous brokers and commission firms.”).

204. 146 CONG. REC. S11,926 (Dec. 15, 2000) (statement of Sen. Lugar) (“By refraining from altering certain sections of the Act, this legislation re-affirms the importance of specific authorities granted the CFTC [T]he Commission has consistently used Section 4b to combat fraudulent conduct.”).

205. *Id.*

acting “for or on behalf of” someone else.²⁰⁶ Because Congress did not include this broadening language in the security futures portion of the legislation, one could deduce that it did not intend the language to apply to security futures.²⁰⁷ Thus, by specifically reserving the application of 4b to certain situations within the CFMA and declining to apply it to security futures transactions, Congress’ actions suggest both a negative implication and an intentional decision.²⁰⁸

Statutory construction notwithstanding, several members of Congress stated in their introductions of the bill that 4b is a general antifraud provision, meant to protect the entire futures market.²⁰⁹ Senator Lugar stated that “[i]t is the intent of Congress in retaining Section 4b of the [CEA] that the provision not be limited to fiduciary, broker/customer or other agency-like relationships. Section 4b provides the [CFTC] with broad authority to police fraudulent conduct within its jurisdiction.”²¹⁰ This statement suggests that Congress intended 4b to apply to all futures transactions.

Although this interpretation may appear to resolve the problem of 4b’s inapplicability to security futures transactions between principles, it is nonetheless, only quasi-legislative intent. Senator Lugar’s statement demonstrates the intent of a *current* Congress discussing *past* legislation, and thus represents only quasi-legislative intent.²¹¹ The only Congress that can state its legislative intent is the one that passes the actual

206. See, e.g., CFMA § 102 (2000) (making otherwise inapplicable section 4b applicable to off-exchange sales of foreign currency futures by FCMs); see also *id.* § 106 (reserving authority to apply section 4b to certain transactions in exempt commodities).

207. *I.N.S. v. Cardoza-Fonseca*, 480 U.S. 421, 432 (1987) (quoting *Russello v. United States*, 464 U.S. 16, 23 (1983)) (“[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.”); see also *Sandoval v. Reno*, 166 F.3d 225, 241 (3d Cir. 1999).

208. See *Field v. Mans*, 516 U.S. 59, 67 (1995) (stating that the negative pregnant rule of construction requires “that an express statutory requirement here, contrasted with statutory silence there, shows an intent to confine the requirement to the specified instance”); see also *Cardoza-Fonseca*, 480 U.S. at 432.

209. 146 CONG. REC. S11,926 (Dec. 15, 2000) (statement of Sen. Lugar); see also *id.* (statement of Sens. Ewing and Combest).

210. *Id.* at 11,926 (Dec. 15, 2000) (statement of Senator Lugar).

211. *South Dakota v. Tankton Sioux Tribe*, 522 U.S. 329, 355 (1998) (“We have often observed . . . that ‘the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one.’”) (quoting *United States v. Philadelphia Nat’l Bank*, 374 U.S. 321, 348-49 (1963)).

legislation.²¹² Although the view of the 106th Congress may shed some light on an earlier Congress's intent, it is not dispositive.²¹³

Nonetheless, even if section 4b does not apply to security futures transactions between principles, principles are still covered by the antifraud provisions in 10b-5.²¹⁴ A legal gap, however, exists between the industries. Uncertainty and inconsistency in enforcement against fraud could increase the potential for regulatory arbitrage by investors and afford competitive advantages for products traded on certain exchanges.²¹⁵ Regulatory parity this is not.

III. POPULARITY OF THE PRODUCT: ARE SECURITY FUTURES WORTH THE TROUBLE?

The September 11th attacks in New York, Washington, and Pennsylvania, the ensuing economic fallout, and a relatively slow moving rulemaking process have served to push back the effective date for security futures trading.²¹⁶ Regulators had hoped to be ready to begin processing trades by early 2002, but the trading delay ultimately extended beyond May of that year and into the second quarter of 2002.²¹⁷ The following section examines the potential popularity of security futures products. Advantages, disadvantages, and proposals about how to achieve security futures success are included.

A. Popularity of the Product: Advantages of Security Futures

Despite this Comment's critical tone, security futures may achieve success, at least mildly, in the institutional arena. Some advantages of these products include lower transactional costs, easier access across

212. *See id.*

213. *See id.*

214. *See* 17 C.F.R. § 240.10b-5 (2001). There is no restrictive "for or on behalf of" language in 10b-5. *Id.*

215. *Joint Hearing on S. 2697, supra* note 49, at 33 (statement of Arthur Levitt, Chairman, SEC) ("Competitive market forces, rather than government regulation, should pick winners and losers.").

216. *Daily Briefing*, ATLANTA J. & CONST., Oct. 9, 2001, at 2C. The CFMA, however, required that security futures begin trading in the retail market on December 21, 2001. CFMA § 202 (2000) (amending 15 U.S.C. § 78f(g)(5)(B)(1994)).

217. *Daily Briefing, supra* note 216; Bill Barnhart, *Single-Stock Futures Get Truly Timely*, CHI. TRIB., Apr. 19, 2002; Alex Skorecki, *U.S. Regulatory Hurdles Delay Liffe Move: Exchange Chief Hits Out at Unexplained Postponements to Allow Trading in Single Stock Futures*, FIN. TIMES (LONDON), Jan. 23, 2002, at 3.

markets, and, despite equivalent margin levels, the potential for a slight margin advantage to be achieved by trading security futures.²¹⁸

Trading security futures offers a significant advantage because they are effectively traded at a lower cost than options transactions.²¹⁹ One security futures transaction may replicate the desired effect of two options trades.²²⁰ Hence, transactional costs for this desired trade would be cut by fifty percent.

Also significant for the potential success of security futures is the ability to trade futures from a securities and options account.²²¹ Futures on individual stocks and narrow-based stock indexes will give securities account holders access to the futures markets.²²² It provides "cost savings for customers, who can do all their equity trading in one place."²²³ Investors' abilities to trade in different industries from one account suggests the opportunity to create substantial leverage, arbitrage positions, and hedging strategies across industries.²²⁴

In their joint-proposed release regarding regulation of margin levels for security futures products, the SEC and the CFTC proposed a flat margin level.²²⁵ This flat-level is based on the comparable short, at-the-money level for equity options.²²⁶ Although the CFMA suggests acting otherwise,²²⁷ the agencies decided to effectively give security futures a slight advantage over equity-based options.²²⁸

Facially, at least, the proposed rules attempt to achieve parity with margin levels of options.²²⁹ The rules set initial and maintenance margin

218. See *infra*, notes 225-233 and accompanying text.

219. Alex McCallum, *Exchanges Draw Swords for Single Stock Futures*, at <http://www.test.crbindex.com/pubs/trader/btv10n3/btv10n3a1.asp> (last visited Aug. 24, 2001).

220. GAO Report, *supra* note 3, at 9-10 ("Options on single stocks serve similar economic functions as . . . futures on single stocks For example, by buying a call option on a single stock and selling a put option on the same stock, a single stock futures contract can be created synthetically.").

221. McCallum, *supra* note 219.

222. *Single Stock Futures are Set to Debut on August 21: Is Anyone Ready to Trade?*, 28 SECS. WK. 1 (Sept. 20, 2001).

223. *Id.* at 1 (citing Paul Stevens, President, Options Clearing Corporation).

224. *Id.*

225. Customer Margin Rules Relating to Security Futures, 66 Fed. Reg. 50,720 (Oct. 4, 2001) (to be codified at 17 C.F.R. pts. 41 & 242).

226. Proposed Customer Margin Rules Relating to Security Futures, 66 Fed. Reg. 50,720 (Oct. 4, 2001).

227. CFMA § 206 (2000) (amending 15 U.S.C. § 78g(c)(2)(B)(iii)(I) (1994)).

228. Proposed Customer Margin Rules Relating to Security Futures, 66 Fed. Reg. 50,720-21 (Oct. 4, 2001).

229. *Id.*

levels for each long or short security future's position at twenty percent of the current market value of the underlying security.²³⁰ The rules also contemplate the effect of double transactional costs such as those in synthetic security futures.²³¹

However, the rules only "allow," but do not require, the national securities exchanges to implement lower margin requirements for such "hedging strategies."²³² Therefore, coupled with the double transaction fees for synthetic security futures, the possible payment of two separate sets of margin requirements, one for the "call" option and one for the "put" option, could provide a slight advantage to security futures over equity-based options.²³³ Depending upon whether the exchanges decide to give security futures this edge, investors may be given an incentive to trade security futures over equity-based options.

*B. Popularity of the Product: Many Issues Have Been Left Unresolved and Security Futures Likely Will Not "Hit the Ground Running"*²³⁴

Security futures are essentially a solution without a problem.²³⁵ Internationally, security futures have not met much demand,²³⁶ and many suggest that there will be a similar lack of enthusiasm in the United States.²³⁷ This lack of enthusiasm results, in part, from the regulatory hurdles and legal uncertainty of trading security futures. Contributing equally though, is the inability of investors to classify these new instruments.²³⁸ Security futures essentially straddle the institutional and retail markets, leaving them without adequate classification in either category and without a genuine trading class.²³⁹

230. *Id.*

231. See *supra* notes 63-66 and accompanying text (discussing how a synthetic security future can be created by buying a "call" option on a single stock and selling a "put" option on the same stock).

232. Proposed Customer Margin Rules Relating to Security Futures, 66 Fed. Reg. 50,720 (Oct. 4, 2001).

233. *Id.*

234. Allison, *supra* note 56 (security futures may not "hit the ground running") (quoting Jon Najarian, Founder Mercury Trading).

235. Simons, *supra* note 155.

236. Nasdaq Press Release, *supra* note 56 (describing how popularity of security futures on LIFFE has been somewhat slow); see also GAO Report, *supra* note 3, at 11.

237. Allison, *supra* note 56.

238. *Joint Hearing on S. 2697*, *supra* note 49 (statement of Arthur Levitt, Chairman, SEC) (stating that the bill to repeal Shad-Johnson "is taking basically an institutional product, a product that has been used by professional investors, and turning it into a retail vehicle").

239. See *id.*

The popularity of security futures products may be greater in the institutional market than on the retail side because institutions have the “sophistication and research tools to use [them].”²⁴⁰ Phil Johnson, former-Chairman of the CFTC, concluded, however, that “the CFMA allows institutions to trade off-exchange among themselves, where they wouldn’t have to put up margins or deal with the higher tax rates The institutions will have to make a serious choice.”²⁴¹ Security futures products were intended to be a retail investment option,²⁴² but will likely turn out to be a misregulated institutional trading product.

Regulatory tension, interagency confusion, and lack of interest in the product will scuttle, at least initially, the popularity of security futures. This Comment concludes by proposing steps the agencies and Self Regulatory Organizations (SROs) should take in order to limit legal uncertainty and enhance the popularity of security futures.

C. Popularity of the Product: Steps to Take to Achieve Security Futures’ Success

Before security futures can start trading and in order to reduce legal uncertainty, the above-mentioned regulatory hurdles must be overcome. Once these issues are resolved, there are several steps the agencies and SROs should take in order to effectuate a successful introduction of security futures.

An underlying goal of the CFMA and the rules promulgated pursuant to that Act is the capturing of the spirit of a competitive marketplace.²⁴³ Congress attempted to preserve that general mood of competition and innovation in the Act.²⁴⁴ Accordingly, the establishment of several

240. *Single Stock Futures*, *supra* note 222 (quoting Paul Stevens, President, Options Clearing Corporation).

241. *Id.*

242. *See generally Joint Hearing on S. 2697*, *supra* note 49.

243. *Id.* (statement of Sen. Lugar) (“The goal of this legislation is to ensure that the United States remains a global leader in the derivatives marketplace.”).

244. *See id.* (statement of Sen. Lugar); *see also Hearing on H.R. 4541*, *supra* note 1 (statement of Mark D. Young, Partner, Kirkland & Ellis on behalf of the Board of Trade of the City of Chicago and the Chicago Mercantile Exchange) (stating that the CFMA “promotes competition . . . [and, as a result, the CBOT] and the Chicago Mercantile Exchange are restructuring and reorganizing their business operations to maximize the chances of capturing the benefits of new technology and innovations.”). Although this Comment argues against joint regulation of security futures because “the very fact that we have two regulators regulating similar segments of the market provides us with some irrationalities to begin with,” the CFMA might actually foster competition for investors across the marketplaces of BDs and FCMs. *Joint Hearing on S. 2697*, *supra* note 49

competing markets is a prerequisite for the success of security futures. This is already under way.²⁴⁵ Equally essential, though, is achieving fungibility in products and mandating uniformity across trading platforms.²⁴⁶

If the introduction of security futures has done nothing else, it has made market boundaries murkier and forced traditional rivals to work together. Not only have the CFTC and the SEC mutually acquiesced to share regulation for the good of the product, but three other groups have teamed-up as well. The CBOE, the Chicago Mercantile Exchange (CME) and the CBOT, the three big Chicago derivatives exchanges,²⁴⁷ have agreed to create a system for trading security futures.²⁴⁸ The commitment of these historically fierce rivals indicates the potential significance of being first-to-market with a platform to trade U.S. security futures.²⁴⁹

In March 2001, the Nasdaq Stock Market (Nasdaq) and the London International Financial Futures and Options Exchange (LIFFE)²⁵⁰ formed a joint venture to create a platform to rival the Chicago market.²⁵¹ LIFFE has been trading futures contracts on "universal" stocks since the beginning of 2001.²⁵² The joint venture promises not only to expand the European security futures market, but to initiate the U.S. security futures market through LIFFE CONNECT, LIFFE's electronic trading platform.²⁵³ Therefore, U.S. security futures trading on Nasdaq-LIFFE will be conducted entirely electronically, a concept the futures market is still struggling to appreciate.²⁵⁴ On August 22, 2001, the CFTC granted "contract market designation" to the joint venture between Nasdaq and

(statement of Arthur Levitt, Chairman, SEC); see generally *Single Stock Futures*, *supra* note 222.

245. Allison, *supra* note 56; see also Nasdaq Press Release, *supra* note 56.

246. *Workshop on Operations*, *supra* note 142, at 8, 11-13.

247. Nikki Tait, *Americans Poised to be Offered Contracts: Single Stock Futures*, *FIN. TIMES* (LONDON), June 21, 2001, at 3.

248. *Id.*; Allison, *supra* note 56. Trading in this new market will be accessed via an electronic medium. *Id.*

249. Tait, *supra* note 247, at 3.

250. LIFFE was established in 1982 and is "one of the leading markets for exchange-traded derivatives." Nasdaq Press Release, *supra* note 56.

251. *Id.*

252. See *supra* notes 55-57 and accompanying text.

253. Nasdaq Press Release, *supra* note 56.

254. See *id.*; see also Tait, *supra* note 247. Another aspect the futures market might be struggling to appreciate is how to transact contracts in decimals, as mandated by the CFMA. CFMA § 202(b)(2) (2000) (amending 15 U.S.C. § 78s(b)(1994)).

LIFFE, the first such designation to be issued for a security futures market.²⁵⁵

World financial markets have increasingly become global entities.²⁵⁶ Trading will continue to expand not only across sectors and exchanges of the United States, but cross-continental markets will grow as well.²⁵⁷ This global economy, small-world approach will provide for stiffer competition, enabling investors to reward innovation in products and services. Increased connection between world markets should also promote the development of an intermarket linkage system for security futures, offering greater liquidity, less volatility, and enhanced popularity, all contributing to the success of security futures products.²⁵⁸

Once there are several markets on which to trade security futures, success will depend on the creation of a national intermarket linkage system.²⁵⁹ Such a system must allow security futures positions to be fully fungible across multiple exchanges.²⁶⁰ Full fungibility would allow exchanges to battle each other over transactional benefits for investors, thereby fostering a truly competitive market.²⁶¹ Ultimately, linking exchanges would provide a more liquid, less volatile, and more popular method of trading security futures.²⁶²

The CFMA, however, does not permit an intermarket linkage system until at least two years after security futures begin trading.²⁶³ If trading volume fails to reach a certain level, the national market system cannot

255. CFTC Press Release 4559-01, *CFTC Recognizes New Joint Venture Exchange for Single-Stock Futures*, Aug. 22, 2001, at <http://www.cftc.gov/opa/press01/opa4559-01.htm>.

256. See, e.g., Nasdaq Press Release, *supra* note 56.

257. *Id.*

258. *Workshop on Operations*, *supra* note 142.

259. *Id.* In 1975, Congress recognized the importance of establishing a National Market System in the securities markets by enacting 15 U.S.C. § 78k-1 (2000) (Section 11A of the 1934 Act). A similar system is equally vital to the success of security futures products. *Id.*

260. *Workshop on Operations*, *supra* note 142, at 8; see also Simons, *supra* note 91.

261. For example, the proposed margin rules would allow individual exchanges to decide whether to allow a margin discount for certain hedged strategies such as synthetic security futures. See *supra* notes 231-233 and accompanying text.

262. See *Single Stock Futures*, Remarks by CBOE Chairman and CEO, William J. Brodsky to the Investment Analysts Society of Chicago (Mar. 1, 2001), at <http://www.single-stock-futures.com> (discussing the importance of liquidity in the new security futures market).

263. CFMA § 206(a)(7) (2000) (amending 15 U.S.C. § 78f(h)(7)(C)(1994)). The provision specifically defers establishment of an intermarket linkage system until the later of two years after security futures start trading, or six months after trading reaches a volume of ten percent of the average volume of options on equities. *Id.*; see also Tait, *supra* note 247.

be established.²⁶⁴ The dilemma, therefore, is that if a lack of volume prevents the establishment of a national market system, the volume will likely never reach the requisite level.²⁶⁵ The problem is circular. Specifically, initial unpopularity is likely to breed perpetual unpopularity. The lack of an intermarket linkage system could restrict liquidity, making it more difficult to find a buyer or seller for the product. Consequently, the lack of liquidity would likely increase volatility and result in stricter regulation and less retail interest in the product. Until options contracts on security futures become legal to trade,²⁶⁶ which will introduce a whole new array of issues, institutional trading will likely be lean as well.

IV. CONCLUSION

The U.S. financial markets have undergone significant changes over the last decade and will continue to evolve as investors look for new opportunities to create wealth. Regulators must adapt to the rapidly moving and continuously developing needs of investors in order to better protect, stabilize, and reform the capital markets. They must do so, however, without compromising legal predictability. Even if security futures achieve wide-spread support and popularity, joint regulation by the CFTC and the SEC creates more uncertainty than it resolves. Ultimately, only time will tell the magnitude and the effects of this uncertainty.

264. CFMA § 206(a)(7) (2000) (amending 15 U.S.C. § 78f(h)(7)(C)(1994)).

265. *Id.*

266. Options contracts on security futures are statutorily banned from trading until December 2003. CFMA § 206(a)(6) (amending 15 U.S.C. § 78f(1994)).